Investing in Real Estate

- REITs are a common component to most portfolios managed by COMPASS due to their diversification benefits.
- REITs have also been one of the best performing asset classes over time as well, often supported by attractive dividend yields.
- When possible, it is best to locate REIT mutual funds (or REIT stocks) in retirement accounts to shelter the income they generate from income taxes.

Investors can gain access to commercial property through real estate investment trusts, or REITs. These trusts have attained attractive returns over the past 30-plus years, providing investors with the income earning potential of bonds and the price appreciation of stocks. With REITs, you may get the best of both worlds.

There are three types of REITs: equity, mortgage, or a hybrid of the two. Equity REITs invest in, or own, commercial real estate and use property rents as revenue. Mortgage REITs invest in loans secured by real estate, earning income through mortgage interest and fees. This article will concentrate on equity REITs, which make up a great majority of listed REITs, according to the National Association of Real Estate Investment Trusts (NAREIT). In fact, if you are interested in learning more about REITs, NAREIT can provide a lot of useful information.

A company must satisfy certain criteria before it can be classified as a REIT. First of all, the company has to be in the real estate business, and at least 75% of its assets must be real property. At least 75% of the company's revenue must come from real estate, and (this is rather important for investors) at least 90% of taxable income must be distributed annually to shareholders. For this reason, REITs can be considered good income-producing investments.

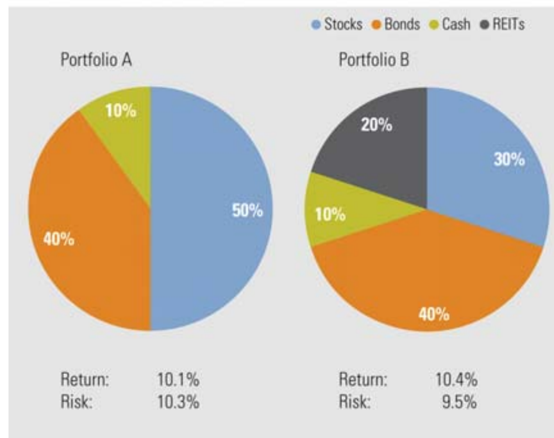
A portfolio of stocks, bonds and cash improves through the addition of REITs, due to the power of diversification. Because each type of asset does not react identically to the same economic or market events, combining them can often produce a higher return with less risk.

Take the example below. Portfolio A consists of stocks, bonds and cash. The portfolio's total return from 1972 to 2013 was 10.1% with a risk of 10.3%. Now look at Portfolio B, which had a 20% allocation to REITs over the same time period. Not only was its return higher at 10.4%, but its risk was also lower, 9.5%.

Nowadays, REIT investing does not have to be limited to the United States anymore. It's true that the U.S. still holds the largest percentage of the global real estate market capitalization, but more and more countries are introducing REITs, especially in Europe and Asia, creating more investment opportunities. Hong Kong, Japan, and Singapore are growing real estate markets in Asia, while the United Kingdom, France, and the Netherlands are developing in Europe.

Do keep in mind that diversification does not eliminate the risk of investment losses, and that REIT investments are not suitable for all investors.

Potential to Reduce Risk and Increase Return: Stock and Bond Investors 1972–2013



Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while returns and principal invested in stocks and REITs are not guaranteed. An investment cannot be made directly in an index. Past performance is no guarantee of future results. The average return and risk are represented by the arithmetic annual return and annual standard deviation, respectively. Standard deviation measures the fluctuation of returns around the arithmetic average return of the investment. The higher the standard deviation, the greater the variability (and thus risk) of the investment returns. Portfolios are rebalanced annually.

Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and REITs by the FTSE NAREIT All Equity REIT Index®.